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**“The encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.”**

**Jean Baptist Say, *Of the Demand or Market for Products*, 1803**

## BOGUS RECOVERY

The upward revision of fourth-quarter real GDP growth from 0.2% to 1.4% has immediately rekindled the old euphoria about America's New Economy. All of a sudden, it is on course for 4–5% real GDP growth, and all the woes that had surfaced during the winter are readily forgotten.

There is but one single thought left: recovery, recovery, recovery. The rest is thoughtlessness.

To gauge the U.S. economy's true prospects, two unusual features of the recent downturn have to be realized. One is the profits implosion. The other is the fact that, *for the first time in history*, a major economy has slumped against the background of rampant money and credit expansion.

In this issue, we take a close look at two topics of prime importance for the U.S. economy's future performance. In the first place, we show that the prevailing, almost euphoric recovery forecasts lack any reasonable foundation. And second, we extend our probe into those features that crucially determine sustainable, supply-side economic growth: profits, savings and net capital investment. During the past few years the three have been literally devastated.

We also have to point out that we have decided to focus on current-dollar numbers, rather than inflation-adjusted “real” data. The former are really the ones that matter for economic activity, and the latter have been increasingly fudged with manipulated price indexes.

## THE CONSUMER TO THE RESCUE, AGAIN...

If this U.S. economic downturn was not caused by tight money and credit, what else, then, has done it? Economic reason points to a single outstanding cause: the very unusual profits implosion that started during the boom. Plummeting profits kindled the capital-spending bust, which curtailed employment and the growth of consumer incomes.

Plunging business capital spending progressively slashed the growth of consumer incomes from \$404.7 billion in 2000 to barely \$40 billion, annualized, in the second half of 2001. Yet the consumer was willing and able to largely offset the dramatic income loss by heavier borrowing. While business fixed investment plummeted by \$134.1 billion in 2001, consumer spending rose \$293.6 billion. Thanks to this spending spree, the U.S. consumer prevented America's deepest and longest recession—for the time being.

Is the debt-laden consumer able to sustain his borrowing and spending spree? Ever since the 1920-30s, American economists have viewed consumer purchasing power as the key condition for economic growth. Overwhelmingly, consumer spending is thought of as *final* demand, from which the demand for fixed capital investment derives. But this is putting the cart *before* the horse. First investment and production have to create income for the consumer before he can spend.

## CYCLE VERSUS BUBBLE

There are two types of business cycle: minor and major. Minor cycles mainly reflect minor fluctuations in inventories. They last on average about one year and are generally “V”-shaped. The major cycles, on the other hand, are rare events and play out over 10 years or more. They involve unsustainable spending bubbles in capital investment, both nonresidential and residential, and/or in consumer spending.

The six U.S. recessions since World War II involved significant downturns in residential building and business capital spending, yet their main feature was inventory liquidation. Once that ceased, production soared upward even in the absence of rising demand. But the U.S. economy’s recent boom and current downturn follow a very different script.

The primary hallmark of a bubble economy is credit and debt excesses running completely out of control. Related secondary hallmarks are more or less drastic shifts in the pattern of spending, and accordingly in the economy’s pattern of economic growth. In the U.S. economy’s bubble years of the late 1920s, the main excesses were in consumer spending, while businesses exercised restraint and retired debt by increasing equity. During Japan’s bubble years in the late 1980s, the asset bubble overwhelmingly fueled commercial building and business fixed investment.

The present U.S. bubble pattern is unique in several ways. Unique above all was that both businesses and consumers participated with full force in the borrowing and spending spree. Private households borrowed as never before to spend on consumption and to speculate in the stock market. Heavy business borrowing, on the other hand, went overwhelmingly into mergers, acquisitions and stock buybacks, while net new fixed investment shrank to new postwar lows. Last but not least, the most unusual feature was the extremely poor profit performance.

The pattern of the downturn has been just as unusual. The rout in business profits and capital spending vastly exceeds past experience. At the same time, consumer spending and housing have remained extraordinarily strong. Such an extreme divergence between the two demand components is unprecedented.

The downturn effectively started in 2000, when current-dollar GDP grew by \$505.4 billion. During 2001, its growth dropped to \$174.7 billion in the first half and to \$38 billion, both at annual rate, in the second half. This was a virtual collapse, and most remarkably, it took place despite record-high money and credit growth.

Typically, economic downturns coincide with sharply *slowing* money and credit growth. But in 2001, broad money (M3) expanded by a record \$913.5 billion, about three times the average annual broad money growth rate from 1990-97. Debt by private households and nonfinancial corporations, meanwhile, increased together by a record \$1,109 billion. The financial sector added another \$916 billion to its debts, also an all-time high.

So while economic activity was virtually stagnating, households, businesses and financial institutes piled up another \$2 trillion in new debts. And considering that Alan Greenspan’s Fed slashed its federal funds rate 11 times from 6.5% to 1.75% during 2001, ***the horrendous discrepancy between prodigious monetary input and minimal economic output raises some disturbing questions. For every single dollar of additional GDP, the U.S. economy incurred \$65 of additional debt... hardly a promising start for recovery.***

## IRRATIONAL OPTIMISM

In early March, Mr. Greenspan displayed his usual optimism as he testified before Congress. *“Increasing signs have emerged that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm,”* he said. Yet he also qualified the optimistic outlook as he went on to say, *“The appearance of these signs led the FOMC to keep its policy unchanged in late January, although it retained its assessment that the risks were tilted toward economic weakness.”*

The media largely overlooked this uncharacteristic note of caution from the Fed chairman. And perhaps

understandably so, since just a few days later he returned to his primary task of cheering on the consumption economy.

*“One key consideration in the assessment that the economy is close to a turning point,” he said, “is the behavior of inventories. Stocks in many industries have been drawn to levels at which firms will soon need to taper off their rate of liquidation, if they have not already done so. Any slowing in the rate of inventory liquidation will induce a rise in industrial production if demand for those products is stable or is falling only moderately... But that impetus to the growth of activity will be short-lived unless sustained increases in final demand kick in before the positive effects of the swing from inventory liquidation dissipate. Most recoveries in the post-World War II period received a boost from a rebound in demand for consumer durables and housing from recession-depressed levels.”*

Hinting that America might “experience a significantly milder downturn than the long history of business cycles would have led us to expect” if the tentative indications of improvement are ultimately confirmed, Mr. Greenspan stressed that, “crucially, the imbalances that triggered the downturn and that could have prolonged this difficult period did not fester.” Having said that, he returned to his favorite mantra—It’s the New Economy—identifying real-time information, increased flexibility, deregulation and innovation as its main harbingers.

Above all he emphasized that there now exists “a far more flexible and efficient financial system—both domestically and internationally—than we had just twenty or thirty years ago. As a consequence of increased access to real-time information and, more arguably, extensive deregulation in financial and product markets and the unbundling of risk (through derivatives), imbalances are more likely to be readily contained, and cyclical episodes overall should be less severe than would be the case otherwise.”

Mr. Greenspan is indisputably the world champion in subterfuge. He possesses a unique ability to put sheer economic nonsense into the most sophisticated language. But his extraordinary success in beguiling people also requires an unbelievably credulous audience that refuses any critical examination and reflection.

### **A PRIMROSE PATH TO PROSPERITY**

First of all, we have to say that prolonged economic downturns, like bear markets, are never straight-line affairs. In bear markets, there are countertrend rallies; and in prolonged recessions there are periods when data appear to be looking better. In the winter of 1929-30, the U.S. stock market soared and the economy seemed to recover. The great majority of people believed the worst was over.

On closer look, the pattern of the 2001 fourth quarter’s mini-upturn was not at all encouraging. Except for consumer spending, all private-sector activity remained in retreat. In fact, GDP would have fallen *even despite the big spurt in consumer spending* if not for a jump in government spending, contributing 1.75 percentage points to real GDP growth.

The decline in business capital investment (including inventories) clipped 4.07 percentage points from GDP. Exports continued their slide, taking 1.27 percentage points off GDP, while housing construction shrank for the first time in a year.

Together, government and consumer spending produced 5.83 percentage points of GDP growth. Annualized, that was a big splash for the quarter, but the safest thing to say about both components is that they are certainly not sustainable at this rate.

The consumption spike had its obvious cause in two extraordinary post Sept. 11 events. One was zero-rate financing offered by automakers and some department stores. The other was unusually favorable rates in mortgage refinancing, which spurred about 7.5 million homeowners to refinance in 2001, mostly late in the year.

Freddie Mac estimates that more than \$100 billion was extracted from home equity last year, by far the

highest amount ever. At the same time, households added another \$490.7 billion in mortgage debt, about three times the annual average during 1990-96.

### **JUST A TEMPORARY REPRIEVE**

Has this spurt of GDP growth started a sustainable recovery? That is the paramount question.

Does the sudden, sharp spike in consumer spending mean the Fed's aggressive easing is finally becoming effective? Or was the buying binge just a flash in the pan induced by some extraordinary passing influences, *implying that households have simply borrowed from spending gains that would have occurred in early 2002?*

Considering the grossly imbalanced pattern of the fourth quarter's upturn, the second explanation definitely appears to be the right one.

Actually, there is still another snag. The United States is the only country where statisticians regularly annualize quarterly and monthly numbers. Many people are not aware of that. Others who are aware fail to take it into account. A 6% increase in consumer spending during the quarter, as reported, appears breathtaking indeed. Yet non-annualized, it was an increase of just 1.5%, a number that would hardly cause excitement.

In Europe, the GDP data are reported in a totally different way. The rule is to make two comparisons—one with the prior quarter, and another with the level a year ago. Importantly, the quarterly comparison is not annualized. Thus in Europe the U.S. fourth-quarter data would have been reported as follows: Compared to the prior quarter, real GDP grew 0.35%, and compared to a year ago, it slowed to 0.4% in the fourth quarter, from 0.5% in the third quarter. Rather than exciting people, this would have sobered them.

### **INVESTMENT, NOT CONSUMPTION, LEADS RECOVERIES**

Since World War II, the United States has experienced six recessions and subsequent rebounds. Their salient features were sharp fluctuations in inventories and in capital investment, both in housing and all kinds of business plants and equipment. These components led every downturn, and they were always the decisive first movers on the upside.

While consumer spending also rises and falls with the cycle, its fluctuations are very moderate in the aggregate, virtually trailing GDP growth. During the first two years of the recoveries from recessions, for instance, consumer spending has increased by an average of 9.9%—roughly in line with overall real GDP growth of 10.2%.

The crucial propellant of every recovery has been capital investment in its different kinds. During the first eight quarters of all postwar recoveries, the growth of residential investment averaged 36.7% and that of producers' durable equipment 21.4%.

Incidentally, the two numbers give an idea of the burst of capital spending required to make a recovery self-reinforcing and self-sustainable. Because investment accounts for a much smaller share of GDP than private consumption (typically 15-20% vs. 60-65%), it has to grow at high double-digit rates in order to provide the necessary thrust for the whole economy.

*This means the widely expected U.S. economic recovery is unlikely to materialize without a prompt and strong recovery in business fixed capital investment and housing. Yet current conditions make recoveries in these sectors virtually impossible.*

Housing, for instance, which has never slowed down, is hardly poised for a rebound. Rather, it is a bubble waiting for the needle that will prick it. As for business fixed investment, the big obstacle is the profits carnage.

Great hopes are being put into the inventory cycle as the recovery's spark plug. Annualized quarterly figures may impress. Yet it is of very limited potential, unless fixed capital investment kicks in before its short-lived positive effects dissipate. Over the whole of last year, inventory liquidation subtracted just 1.08 percentage points from GDP growth. Another negative point not to be overlooked is that inventory changes are heavily related to imports.

### **MIRACLE UNMASKED**

It is the essence of bubble economies that developing asset price bubbles grossly overstimulate either consumer spending or investment spending. In the consensus view, the U.S. economy has primarily experienced an unprecedented investment boom in the past few years that has caused excess capacity across the board.

For years, our own view has been diametrically different. Careful analysis of all available data shows unmistakably that the single greatest excess in the U.S. economy during the past several years has been an unprecedented escalation of consumer borrowing and spending, as glaringly reflected in the literal disappearance of personal saving.

And since consumption has been grabbing a rising share of GDP, this logically implies a shrinking share for capital investment. This is why we have long viewed the reported and widely cheered capital investment boom as just another statistical freak of the New Economy.

Traditionally, the United States is a high-consumption, low-saving and low-investment country. And despite all the supply-side fantasies at the time, this pattern only got dramatically worse under Reaganomics in the 1980s.

During the '80s, the net national saving rate fell from over 6% of GNP to a little over 2%. Its main cause was a steep rise in the Federal budget deficit, associated with a lesser decline in personal saving. The dismal counterpart in the economy to this ravage of national saving was ***the lowest net fixed investment ratio*** in the whole postwar period.

As a ratio of GNP, the level of net fixed investment averaged about 5%, nearly two percentage points less than the prior postwar average. The culprit was a sharp drop in business fixed investment (residential building kept up rather well). Net investment in the manufacturing sector led the decline, as it plummeted to zero and stayed there for years.

***To emphasize the main points about the 1980s: Contrary to euphoric expectations and prevailing perceptions, Reaganomics effectively boiled down to massive capital consumption. Its key features were an extraordinary boom in consumer spending, a steep plunge both of national saving and of the rate of capital formation, and a soaring trade deficit.***

***Emphasizing now the most important point of all: All these negative features of the 1980s have deteriorated even more in the 1990s.*** After peaking at \$413.4 billion in 1992, or 8.7% of disposable income, personal savings fell to \$28.6 billion annualized in the last quarter, or 0.3% of disposable income. Business saving, meanwhile (representing undistributed profits), fell from a peak of \$220 billion in 1997 to an annual rate of \$55 billion in the fourth quarter of last year. Combined, private sector saving has now collapsed from around \$500 billion to less than \$84 billion, or from 5% of GDP in the first half of the 1990s to less than 0.5% of GDP.

Oddly, this new savings disaster never found any interest among policymakers and economists. Why? Because business fixed investment appeared to be booming as never before.

### **A PHANTOM INVESTMENT BOOM**

Between 1995 and 2000, the U.S. statistics showed gross fixed investment increasing in real terms at an annual rate of 13%, accounting for 31% of real GDP growth during this period. This vastly exceeded its norm

in the whole postwar period. Never before had it exceeded 14% of GDP. Understandably, this extraordinary investment boom, most of it moreover in the new information technology, became the key argument for a new paradigm economy delivering miracles of productivity and profits.

Judging simply by these numbers, this was the most fantastic investment boom in the history of capitalism, exceeding even the investment boom during Japan's bubble years. But one simple consideration gave immediate reason to doubt the validity of the stellar investment figures: *from a macroeconomic perspective, such a roaring investment boom is flatly inconsistent with collapsing domestic saving.*

One source of confusion is the difference between gross and net investment. In the developed countries, a great part of business fixed investment today replaces plant and equipment that wear out each year, and to this extent there is no addition to the existing capital stock and existing income flows. Strictly speaking, it is net investment, and only net investment, that increases the productive capital stock and income flows.

But difficulties of defining and measuring net investment have caused statisticians worldwide to stick to the gross figures in gauging capital spending. Over time, it became customary to look exclusively at them. For the superficial observer, that's good enough. Yet a more careful assessment of the underlying pattern of economic activity ought to focus on *net new capital investment*.

The Commerce Department regularly publishes figures for gross investment, depreciation charges and net investment. They show a gradual decline of net investment as a share of GDP over the postwar period. This downtrend dramatically worsened during the second half of the 1990s, as soaring consumption sharply expanded at the expense of both net domestic investment and the trade balance.

## **CREATIVE INVESTMENT STATISTICS**

According to data from the National Income Product Accounts, nonresidential fixed investment has ballooned by \$533.2 billion in real terms, or 65%, between 1995-2000. At the same time, real GDP reportedly expanded by 22.2%.

These exorbitant investment numbers certainly played a key role, if not the key role, in creating the euphoric perception of an unfolding productivity and profits miracle. Yet the investment boom was strikingly irreconcilable with the simultaneous savings debacle. Identifying the true origin of the extraordinary investment boom was not difficult: creative statistics.

Between 1995 and 2000 business spending on computers in current dollars actually increased by a mere \$23.2 billion to \$87.8 billion. Hedonic pricing, however, turned that bagatelle into a steep increase by \$240 billion, from \$49.2 billion to \$289.2 billion.

The other major statistical contribution to the appearance of an investment boom in the United States came from the decision of the statisticians to take business spending on software out of expenses and to capitalize it. That added another \$110 billion to real GDP growth during these years.

*Taking depreciation charges, hedonic pricing and software capitalization out of the above-mentioned U.S. gross investment figure of \$533.2 billion, the increase in net nonfinancial investment flattens off to a mere \$110 billion between 1995-2000, or \$22 billion per year, which represents a new record low for the whole postwar period.*

It is the function of hedonic pricing to convert quality improvements into price reductions. We have always had general reservations against this principle, but in the case of computers the statistical effects of this pricing method have reached magnitudes that grossly distort the economic picture, *accounting in the last few years for more than 50% of the increase in industrial production and 14.3% of real GDP growth.*

Generally speaking, it makes economic sense to deduct inflation rates from nominal income and spending

figures in order to measure increases and decreases in real terms. Counting falling prices *as additions to real GDP*, however, is highly questionable. It creates dollars that nobody has spent and nobody received. It may, in fact, *camouflage* shrinking revenues and incomes.

What ultimately matters for economic activity are the dollars effectively spent and received. They alone add to incomes and profits. Think of Japan, where the figures in real terms look a lot better than those in nominal terms.

But our strong preference for nominal figures has still another reason, in particular in the U.S. case. They are not prone to price index manipulation.

Conspicuously, the big gain in U.S. fourth-quarter U.S. real GDP growth diametrically contrasts with a near-zero gain in current dollars. Measured in current dollars, real GDP growth only edged up from 0.9% to 1.1%, both at annual rate, as against the reported dramatic swing in real GDP growth from -1.3 to +1.4%. Here is the explanation.

The biggest single factor for the tremendous discrepancy between real and current figures was the sharp decline in the GDP price index from +2.2% in the third quarter to -0.3% in the fourth quarter. Another major factor was again hedonic pricing of computers, turning a puny increase of \$1.2 billion in current dollars into a sixteenfold increase of \$19.6 billion in “hedonic” dollars.

### **THERE IS BUT ONE KEY TO TRUE PROSPERITY: NET INVESTMENT**

Generations of economists used to consider it a truism that net capital investment is the essence and the key condition for economic growth with rising prosperity. In the short run, while capital goods are produced, net investment creates growing demand and profits; and in the long run, after the capital goods have been installed, it creates growing supply and productivity.

Consumer and government credit, on the other hand, create demand only as long as they keep expanding. Once they stop, the music stops. To propel the economy forward, they have to compound indefinitely. This renders consumer and government credit far inferior to investment credit in the ability to generate self-sustaining economic growth.

*Classical business cycle theory is, at bottom, investment theory. Its central axiom is that investment spending in pursuit of profits by businessmen is the prime and autonomous mover of the capitalist economy. Raising consumption may be the ultimate aim of economic activity, but profitability is the first key condition.*

Production comes forward only when it promises sufficient profit. As businessmen invest and produce in response to favorable profit prospects, they create consumer incomes. Rising consumer incomes and spending, then, derive directly from profit-seeking investment spending, not the other way around.

It is a historical fact that economies with high investment ratios are also high-profit, high-wage, high-saving and high-growth economies. They all condition each other. Japan and Germany were temporarily outstanding examples of this group.

Low-investment economies, by contrast, typically have low savings, low wages and low profits. Britain and the United States are the most prominent examples of this group. Lacking the necessary investment dynamics for strong economic growth, they have become excessively dependent on consumer credit, apparently turning vice into virtue.

America, in particular, wants to break out of this low-investment pattern. The first major attempt of this kind unfolded in the 1980s with so-called *supply-side Reaganomics*.

### **THE FAILURE OF REAGANOMICS**

The main instrument for boosting investment under President Reagan was an unprecedented five-year \$749

billion tax cut. It was assumed that such a massive tax cut over a longer period would accelerate economic growth by inciting more work effort, more saving and more capital investment. In all three respects, the program proved an egregious failure.

Most importantly, the new policy ravaged available net national savings as never before, dropping to a postwar low of 3% from a historical average of 7.5%. This had two main reasons: one was that individuals, spurred by booming stock and real estate markets, slashed their saving out of current income, and the other one was a soaring federal budget deficit.

The tax cut and soaring government spending did in fact spur a recovery—but it wasn't the desired supply-side recovery. Economic growth remained consumer-driven and would become more so over the following years.

We have recalled this experience of the 1980s because of some striking and ominous parallels with the present. Then, there reigned very much the same euphoria about the new policies and the U.S. economy's new dynamics. There was even the very same condescending talk, as today, about a notoriously sclerotic European economy that fails to learn from America.

In reality, it became quite clear early on that the whole tittle-tattle about new supply-side economics lacked the barest foundation. What actually happened was the exact opposite of the hoped-for result.

The most spectacular, negative feature was a dramatic reduction in the amount of savings available for capital formation. The tax cuts completely failed to stimulate capital investment. Instead, net investment in relation to GDP, representing additions to the stock of productive capital, fell sharply. Structures and capital investment collapsed. Manufacturing net investment was zero for many years.

As credit-propelled domestic demand increasingly exceeded the very low capacity growth, the massive domestic dissaving expressed itself largely in an exploding trade deficit. As a result, the United States in the 1980s went from an international net creditor position of 4% of GNP to a net debtor position of 20% by the end of the '80s. Today, that number has reached 35%–40%. In a few years, it should reach 50%—on par with many underdeveloped countries.

Yet declining inflation rates, stronger economic growth, rising employment and a booming stock market led the consensus to believe Reaganomics was a success. But from the perspective of capital formation, the 1980s were an outright disaster for the U.S. economy. In order to maintain even the notoriously low capital investment ratio, more credit was needed from abroad. In essence, it was capital consumption of the greatest order.

### **SPRINGBOARD OR CLIFF?**

Today, this combination of low saving, low net investment and massive debt growth is even worse than in the 1980s. And this brings us to the central issue concerning the U.S. economy's performance in the fourth quarter: Was it the last spasm of the consumer-driven bubble economy, or could it possibly have been the springboard of a self-sustaining recovery?

The evidence suggests it could only have been the last surge before the fall.

Consumer spending rose by \$94.6 billion on an annual basis in the fourth quarter, contributing 4.06 percentage points to real GDP growth. Yet most of this increase took place as a result of low-interest and zero-interest financing deals, as purchases of durables jumped from \$2.1 billion to \$81.1 billion. And even more problematic is how the consumer paid for his purchases.

During the quarter, the U.S. consumer saw his income shrink by \$3 billion while he increased his indebtedness by \$609 billion. Yet at the same time, consumption rose by \$94.6 billion. This means the U.S. consumer *borrowed more than six times the amount he spent!* (All figures are annualized.)

This pattern is ludicrous. So much debt for so little growth is frightening. These are hardly the ingredients for an economic recovery.

### **FROM BAD TO CATASTROPHIC**

The key point here is that this borrowing-spending pattern is definitely unsustainable. It's one of several reasons why the upturn in the fourth quarter cannot possibly be regarded as a nascent recovery. Recessions are periods during which former spending excesses are corrected. This time, the idea is to prevent recession by increasing the excesses.

Historically, private consumption has accounted for about two-thirds of GDP in the United States. The consumption boom of the 1980s pushed the ratio towards 70%. During the second half of the 1990s, that ratio soared further to 77% of GDP growth. In the wake of this raging consumption boom, domestic saving has been virtually annihilated, and the trade deficit ballooned to new records. From a structural perspective, the economy's saving-investment pattern went from bad to catastrophic.

When the swelling budget deficit began to eat into savings in the 1980s, there was a lot of loud worrying from policymakers and economists about it. In the late 1990s, dissaving has dramatically increased. Yet nobody seemed to care two hoots about it. Instead, it has become a popular argument that capital gains in the stock market make saving redundant.

Grasp of the essence and function of saving in the economic growth process seems to have gone into complete eclipse among American policymakers and economists. They see other countries with high savings rates, like Japan, and its economy perilously languishing, while the U.S. economy, with savings in collapse, has been booming. Judging from these experiences, the preferable pattern seems obvious. Better to have no savings than too much of them.

In the short run, that's certainly true. Yet, zero-saving America is running into a protracted structural crisis of its own. The U.S. economy's highly touted consumption-driven growth of recent years has been unsustainable bubble growth. It has been bought with imbalances and debt creation that defy reasonable imagination and that definitely herald a protracted period of very painful readjustment.

### **THE INDISPENSABLE ROLE OF SAVING**

Saving, in actual fact, is the indispensable condition for economic growth because it releases the resources that can be used to produce plants and equipment, adding to the nation's capital stock. But this is true only for saving out of current income, coming from current production. Saving essentially implies abstention from consumption.

A country without genuine saving out of current income is effectively unable to increase its productive capital stock. ***This is not a theoretical assumption; it is a categorical fact.*** Whatever reduces savings essentially reduces investment.

In America, ironically, major capital gains in the stock market, far from replacing saving, have the opposite effect of stimulating dissaving on the part of the consumer. The stockowners, of course, enjoy a corresponding increase in their personal financial wealth. But for the economy as a whole, it is phantom wealth that has added nothing to the economy's future productive capacity. Just the opposite is true: to the extent that the capital gains boost consumer spending at the expense of saving, they decrease the economy's investment and growth potential.

All this leads to another compelling recognition about economic growth: The crucial test of every economic development from the perspective of long-term growth is its impact on available savings (investment resources) and investment incentives (profitability). Together, these are the indispensable key determinants of rising

productivity, rising national wealth and rising living standards. In this process of capital formation, in other words, saving out of current income is just as indispensable as investment.

During the late 1990s, the plunging saving ratio reflected the fact that consumer spending was claiming a rapidly rising share of GDP, eclipsing the same excesses of the 1980s by far. From a macroeconomic perspective, this growing absorption of resources for consumption essentially had two counter-effects: *first*, accelerating imports and related foreign indebtedness; *second*, shrinkage of net capital investment to new postwar lows.

***But how could all this pass unnoticed? There were three obvious, main reasons: fanciful New Economy propaganda; statistical delusions; and a traditional neglect of saving and investment in American economic thinking.***

## **DEALMAKING CAPITALISM IS PROFITLESS CAPITALISM**

The New Economy hullabaloo about an unfolding profit and productivity miracle had two separate sources: alleged wonders of the new information technology, and alleged wonders of the new shareholder value capitalism, by which managers were pressured to maximize efficiency and profits.

Investors were lured and impressed with a completely new vocabulary suggesting ever-greater efficiency: synergies through mergers and acquisitions, downsizing, outsourcing, cost-cutting, exporting jobs, laying off employees, limiting employee pay and benefits, and last but not least, stock buybacks. All these measures were presented to the public as deliverers of productivity and profits. In reality, they all proved synonyms for abstinence from building new plants and equipment. Soaring stock prices effectively suppressed any critical thinking.

For the observer still familiar with the intricacies of divergent micro- and macroeconomic logic, it was clear from the beginning that corporate America's new strategies to maximize profits in the short run were destined to have the opposite effect of *decreasing aggregate profits*. It's a particularly striking case of ill-guided micro logic.

The fact is that most of the new strategies to boost business profits were of the expenditure-cutting type. That's fine for an individual firm, but economy-wide, any cuts in business expenditures implicitly reduce overall business revenues. Macro logic, in other words, showed that individual firms were cutting into each other's revenues and profits.

Business spending's key role as a source of business revenues is a completely neglected aspect of profit creation. To us, it is the main explanation of the U.S. economy's unusually poor profit performance during the past few years. Inherently, dealmaking capitalism is profitless capitalism because it neglects new investment. This capitalism creates phantom wealth for some in the markets, but overall it produces far more debts than national wealth.

## **PRODUCTIVITY FUDGE**

Reading the comments about the U.S. economy's performance in the fourth quarter, the old, false euphoria is clearly back again. A few better-looking numbers were sufficient to discard all the woes about profits and accounting that had surfaced in the past year and a half.

The favorite argument for the return of strong economic growth and sharply rising profits is the apparently sustained productivity miracle. Just think of it: productivity increased in the fourth quarter at an annual rate of 5.2%, a new record. Isn't that testament to corporate America's unique efficiency? Nothing like it can be seen in Europe.

Apparently, it has completely escaped these people's notice that the *reported* productivity miracle has miserably failed to boost profits even during the past several boom years. In actual fact, it was the worst profit performance during the whole postwar period. Essentially, this ought to have raised some critical questions about the validity of the productivity numbers.

Here again, the puzzle's solution lies in the difference between measured real GDP growth and measured nominal GDP growth. In the fourth quarter, the sharp lowering of the GDP price index from +2.2% to -0.3% gave a corresponding big boost of 2.5 percentage points to real GDP growth. And bear in mind, what adds to real GDP adds equally to productivity growth. A further contribution of 0.5 percentage points to real GDP and related productivity growth came from the hedonic pricing of computer investment.

The key point is that both the GDP deflator and hedonic pricing, while adding massively to statistically measured productivity growth, do not add a single penny to business revenues and profits. From the business perspective, this productivity growth is statistical bogus.

### **DELUSION AND DENIAL**

But there is still another major flaw in the conventional assessments of profit prospects. There is a complete neglect of the vital importance of changes in business capital spending for corresponding changes in overall business revenues and profits. In essence, they are really the flows that are crucial in generating profits. The key question, then, is the future behavior of the various capital investment components.

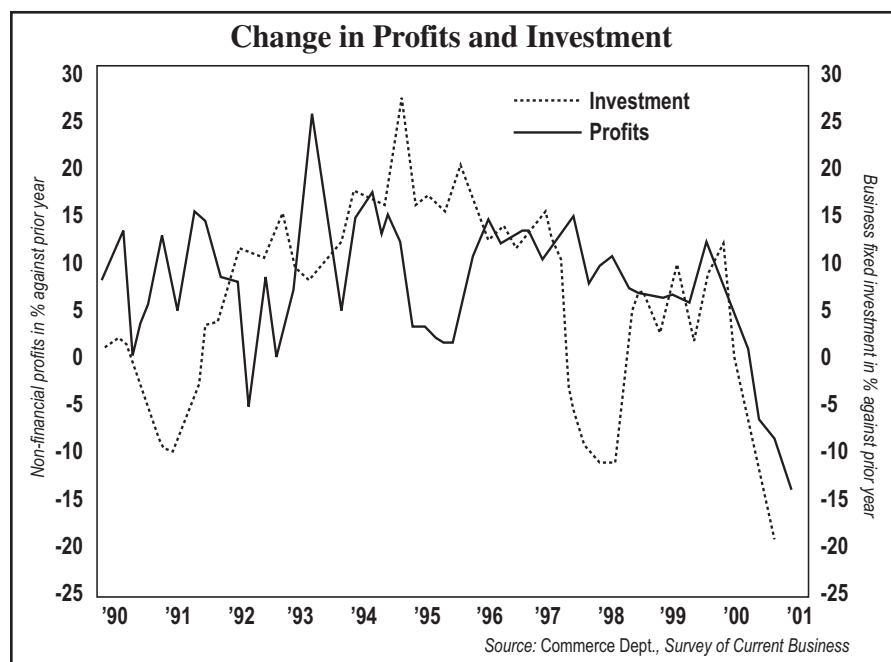
Shrinking investment spending across the board put a squeeze on profits in the fourth quarter. But this was largely offset by the new consumer borrowing/spending spree. This, however, has exhausted itself, while the profit and investment outlook remains as dismal as before.

A lot of fuss is being made of surveys showing high-riding consumer confidence. We put no value into such surveys. Ignorant as he is about the economic prospects, the consumer essentially just rehashes the highly optimistic expectations that the experts and media pump into him.

*What really matters for the consumer's future spending is not his present confidence but his ability to spend as determined by the hard financial facts facing and awaiting him: stagnating or falling income, rising unemployment, soaring indebtedness and renewed wealth destruction by plunging stock portfolios.*

Yes, confidence is very important. No less important, though, is the distinction between justified and unjustified confidence. Unjustified confidence is the primary cause of all borrowing and spending excesses and the following crisis. Growth and profit expectations about the U.S.

economy in the past few years have been ludicrously inflated with fairy tales about a productivity miracle fueling a profit miracle. The reality was the poorest profit performance of the whole postwar period.



It was reasonable to expect that the economy's downturn would substantially dampen these inflated expectations. However, delusion and denial continue in full force. Uncritical public opinion, including unbelievably uncritical economists, has been beguiled into the illusion that this downturn had its main causes in psychological effects of the Sept. 11 terrorist attack and a temporary inventory liquidation.

It all comes back to the unique character of the present U.S. economy's downturn. The key consideration to start with is that the boom of the past few years was not the outgrowth of a New Economy but of a bubble economy with devastating effects on capital formation. On closer look, this bubble consisted of a variety of subordinate bubbles: a consumption bubble, financial bubble, dollar bubble, stock market bubble, real estate bubble and, of course, a bubble of grossly inflated expectations.

While the Bank of Japan deliberately pricked its bubble in the late 1980s with tight money, the Fed is trying to sustain the U.S. bubble with ultra-loose monetary policy. Such an effort has no precedent in history. So far, Mr. Greenspan's attempt appears rather successful, except for a partial deflation of the stock market bubble. But that's only so far...

Over the longer term, we think, it is madness and bound to fail. On the other hand, the unsustainable excesses and imbalances already accumulated in the economy and the financial system are of such preposterous magnitude that any tightening would in any case come much too late to avoid disastrous consequences.

## **CONCLUSIONS:**

Despite what has happened, irrational exuberance about the U.S. economy lives on. An up-blip in real GDP growth during the fourth quarter owing to a new bout of consumption and borrowing, heavy manipulation of the price indexes and the practice of data-annualizing has immediately kindled wild fantasies about an economic recovery. There is no sense of how such a recovery would be sustained.

Policymakers, economists, consumers and the media remain in unflinching denial. They refuse to see that the U.S. economy and its financial system are in serious trouble. But those who know best, corporate managers, remain rather gloomy, though perhaps less than they should be.

Further tax cuts and some rebuilding of inventories may produce one or two new up-blips, but a sustainable, sufficiently strong rebound depends ultimately on double-digit upturns in the various categories of capital spending which, in turn, depend on sharply improving profit prospects.

Doing our regular macroeconomic analysis of profit sources, we identify overwhelming risks for profits to the downside. The most obvious and single greatest danger is that the consumer should return to saving from current income. It would smash profits and drive the U.S. economy into a prolonged Japanese-style recession. The U.S. equity market is undergoing a bear market rally. A steep fall is to follow when the failure of recovery is realized.

## **THE RICHBÄCHER LETTER**

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